THE FINANCIAL MENACE TO AMERICA OF THE EUROPEAN WAR

By Simon N. Patten, Ph.D.,
Wharton School of Finance and Commerce, University of Pennsylvania.

In a national crisis there is difficulty in applying old principles to new situations. It is often said that there is nothing new, every situation being the repetition of antecedent experience. It is equally valid to assert that new conditions demand a restatement of old laws; only through such reconstruction can they be applied to current events.

An attempt to apply the economic theories to the present situation shows a confusion that exists, not so much on account of the fallacy of principles as on account of the particular way in which they have been stated. The data on which they depend have not been worked over, and as a consequence the theories have remained rather as statements of particular forms of experience than as its general statement. This is especially true of the economic doctrines that arose in the last century, since their essence is distributive. Their goal is some rule by which the produce of society can be divided among the various producers. The real question today is how much of the national wealth can be taken from producers and given to the state. The present situation in Europe is described by saying that, in the past, 10 per cent of the annual income of each country has been turned over to the state, while under the new conditions 40 per cent of the annual income must be given to meet the increase of public expense the war involves. How far this can be done and in what ways without interfering with the processes of production is the vital issue. We have thus to do with the total income of the nation, not that of some class or industrial group; only the most material wants are to be kept in mind.

If 90 per cent of the total revenue of England in the year 1913 was devoted to the private uses of its citizens, how can they adjust themselves in 1915 so that 40 per cent of the total income of the nation can be turned over to public uses? If this much is demanded of England, still more is demanded of the people of France or Ger-

many, if they are to meet the situation imposed on them by the European conflict. If this view is taken, certain fundamental relations between people and environment must be maintained to carry on a long struggle under conditions where the resources of the nation go to public needs rather than to private uses.

The first of these is the relation between food and population. Deductions in this field are known as the law of diminishing returns. It is not necessary to discuss the implications from this law as all nations are conserving their food supply and endeavoring to increase it by every means in their power. The relation between capital and industry may occasion more difficulty. Here we find the law of economic cycles, as it has been called by Professor Moore, to whom its best statement is due.[1] Fluctuations in industry are primarily alterations in the annual production of commodities. A series of good years cause also increasing industry and rising industrial values, while a series of bad years result in depression and disaster. Such cycles have come in the past with great regularity, and they show us the danger to industry from any diminution in the total of the food of the community. The importance of this law is, however, not so much in any anticipated diminution of the food supply, but rather that it throws light on what will happen in a community where there is a large decrease in the quantity of capital.

In the past, changes in values have come from fluctuations in the amount of crops. There has never been a material decrease in the quantity of capital, and usually there has been from year to year a decided increase. Now for the first time we face an actual decrease in quantity of capital. How are we to measure its effects on values and on industry? The reply is that its effects will be similar to the effects coming from a diminution in the annual yield of the farms. A poor crop is as much a destruction of wealth as if the crop were produced and then destroyed. If this is true, other types of destruction will have the same general effect on industry.

If we look to the relation of food and population for the basis of our static relations and to the relation of capital to industry for our fluctuating changes, we should measure the progressive changes in society through the relation between the present and the future of which the rate of interest is the best expression. One group of economists assert that interest depends upon productivity, and

[1] *Economic Cycles: Their Law and Cause.*

therefore rises and falls as productivity increases or decreases. Other economists affirm with equal earnestness the theory that the rate of interest depends upon the estimate individuals make of their future welfare. Are we to look upon these two laws as opposing tendencies or as reflecting different conditions under which the rate of interest manifests itself? To my mind, they represent two elements whose combined influence determines the rate of interest. People cut down their present consumption in favor of future consumption, through the fear of future want. Any new conditions diminishing the fear of future want will check the tendency to save and cause an increase of present consumption. The diminution of fear means a rising rate of interest. On the other hand, whatever reduces the risks of industry tends to create a lower rate of interest. Industrial progress is thus from a state where fears are static while risks were diminishing to a condition in which fears are diminishing and risks are static.

Let me explain this formidable but after all simple proposition. For a long time the social conditions under which industrial people lived remained the same, their anticipation of future dangers were correspondingly fixed, and hence the same motive from generation to generation existed to set aside a part of their income to provide for future contingencies. Two generations ago it could be said that if the family income was increased from $1,000 to $1,200, the $200 additional would, in nine cases out of ten, be turned into capital. During this time, however, the risks of industry were diminishing, and as a consequence, the element of danger was reduced. The net result is a falling rate of interest. At the present time, however, risks have come so near their minimum that they are a static element. People think less of tomorrow than their forebears did. There is an increase in present expenditures by those whose forefathers would have saved.

In general terms, we can say that an increasing product raises the consumers' margin and creates a rising rate of interest. The rate of interest is an index of the progressive changes taking place just as is the law of diminishing returns of our static relations. We thus have a law of static change, a law of fluctuating change, and a law of progressive change. These three laws I shall attempt to apply in determining the danger that American industry fares as a consequence of the present war.

The first question to decide is whether industry has been so disarranged that its returns have diminished. During the Napoleonic wars, England was undergoing a tremendous industrial revolution that increased her productive power from 50 to 200 per cent. The result was that after the twenty years' struggle England found herself richer than before. The expenses of the war had reduced the profits of the nation, but had not destroyed them. The same result followed our Civil War. New inventions in agricultural machinery were introduced to such an extent that the diminishing labor supply caused by the enlistments was more than made up by the increase in the power of machinery. As a result, the North found itself wealthier at the end of the war and the rate of profit was also larger than at the beginning. These two examples are often used in a confusing way because they seem to show that war brings prosperity, when in reality they only show that war is a burden a nation can stand if the increase in productive power is sufficiently great. At the present time, with no great industrial improvements in sight, it seems wiser to assume that the burden of the war will rest upon the nations who have taken part in the struggle. How will this burden be distributed, and upon whose shoulders will it fall? In answering these two problems we are likely to be confused. When we discuss the effect of the war on securities we should have in mind, not the ultimate value of these securities twenty or thirty years from now, but what will be their immediate value at the close of the war. After every period of food shortage there has been a depression in industry and in security values. We can infer from this what will follow in the present case for the destruction of war illustrates the same causes as a shortage of food. If bad crops create depression, we have a right to infer that a like depression will follow the destruction caused by war. Professor Moore's conclusions are that the depression in industry lags four years behind the shortage in agricultural crops, and if this holds in the present case, we can infer that the burden of the war will be settled by an industrial depression in the near future.

This inference is justified by what we know of the relation of wealth to value. An increasing product causes a still greater increase in value, while a diminishing product has a powerful effect in lowering values. It is hard to express this relation in simple mathematical terms, but it is an understatement of the facts to say that

a reduction in product produces a double effect in value, and therefore a reduction of 10 per cent in produce may produce 20 per cent in reduction in industrial values.

It is universally admitted that the cost of the war for one year is about $15,000,000,000 to the nations concerned. If we take into consideration the losses of private property in Belgium, Poland, France, and other places actually within the war zone, and the disturbance of industry in other regions, a like destruction of $15,000,000,000 has resulted. We thus have an actual destruction of property to the amount of $30,000,000,000, and if the loss in value is double the loss of product, we must assume that at the end of the year the value of the world's capital has been reduced by $60,000,000,000. As the world's total wealth foots up to something like $300,000,000,000, this means that at the end of the year there has been a loss of 20 per cent in values if the distribution of these losses were equal. That, however, is not likely to be the case. What usually happens under such circumstances is, not an even fall in values and an even burden upon all industry, but rather a commercial crisis in which the losses are unequally distributed, and thus greatly increased. If the war continues more than a year, the losses will be enormously increased and the difficulties of readjustment correspondingly great. I do not, however, from this, wish to infer that the total value of the world's wealth will be permanently decreased. No matter how destructive the war is, none of the permanent resources of the world will be disturbed, and sooner or later the liquidation of the losses will take place and then the recreation of values will follow, giving a higher total value than before. Such, at least, has been the result of all the financial crises in the past. It is risky, therefore, at the present time to hold securities no matter how safe they appear to be because they will be seriously affected by the industrial collapse that is bound to follow the closing of the war. The risk in regard to bonds and the effect that the war will have on them is different because the bond market is determined, not so much by the fluctuation in the relation of wealth to value nor by the current rate of profit in the community, as by the rate of interest. A high rate of interest results in a relatively low value of bonds and securities, while a low rate of interest correspondingly raises the value of stocks and bonds. We must determine whether the rate of interest is changing in a way that will

affect the value of bonds. If the American people have to a considerable degree stopped saving, a rise in the rate of interest must take place in order to counteract the growing tendencies toward immediate consumption.

In the past, we have had three classes of savers. The laboring population has its saving measured by the amount in savings banks. There is no reason to assume that they will fall off in the immediate future. The same I take it to be true of the large saver—a man whose income is above $5,000. If the savings of the wealthy are decreasing, it is more likely to be the result of increased taxation than any change in their character or motives. There is an eagerness on the part of the public to tax this class, and should it take the form of income or inheritance taxes, the savings of the wealthy will be absorbed, and thus limit the additions to capital that now take place. The most interesting group to study is the middle class, those whose family incomes range from one to five thousand dollars. This class has practically ceased to save except as it affects life insurance and the education of their children. They are even ceasing to own their homes. The tendency at the present time is to rent an apartment rather than to live in a house. The eager desire for consumption produces a pressure upon their incomes that causes them to expend all they earn.

These changes may take a generation to work but in the end the normal rate of interest will rise from 4 to 6 per cent. If this prediction proves correct, any person investing in bonds having many years to run will lose 20 per cent of their value when the final payment is made. It is probable that the rate of interest will remain low for a time, but all the more certainly can we predict that a person thinking of his welfare twenty years from now will suffer very serious losses if he buys long term bonds at present rates. The change in values that affects stocks will be immediate but temporary, while the changes in the value of bonds will be slow but permanent.

An illustration will fix these facts more clearly. Take a corporation with an income of $100,000 a year, $40,000 of which goes to pay the interest on a million dollars in bonds, while $60,000 pays dividends on one million in stocks. Both bonds and stocks would be at par if the interest rate were 4 per cent and the average return on investments were 6 per cent. If a rise in the interest rate from

4 to 6 per cent occurs and a corresponding rise in the return on investments increases from 6 to 8 per cent the average profit of industry, the value of the bonds would fall to $670,000 and that of the stock to $750,000. This would be the initial loss. When the bonds are refunded on a 6 per cent basis, $60,000 instead of $40,000 a year must be paid as interest on the new bonds. This leaves the stockholders a net return of $40,000 a year which on an 8 per cent basis would give their stock a value of $500,000. The industrial loss of a 2 per cent rise in the rate of interest can be estimated as follows: bonds 20 per cent; farm values, 30 per cent; stocks, 40 per cent; city real estate, 50 per cent. To offset these losses are the gains from inventions and new industrial processes which, however, everyone must estimate for himself.

This does not fix the real loss America must suffer. It is not the treaty of peace that settles the burden of the war, but the financial adjustment following the crisis which the war creates. The French did not pay the indemnity at the close of the Franco-Prussian War. The ownership of the world's resources was settled by the crisis of 1873 with its destruction of values. The great losses were those of Germany and America and they were thus the real payers of the war expenses.

It should be remembered that at present America is getting nothing but paper credits for the enormous export of food and arms. Imports have fallen off and little gold is imported. The financial crash at the close of the war alone will determine the value of this paper. How much will the farmers gain from selling their wheat for an advance of fifty cents a bushel if at the close of the war their land falls 20 per cent in value? If two billion dollars' worth of securities are returned in exchange for food and war material while the crisis lowers all our stocks and bonds by 20 per cent, we have not only given the food and arms to Europe for nothing but have also paid a bonus. We figure out great profits today, but they are after all only paper promises. Tomorrow the reckoning will come and then the holders of securities will bear the burden. Happy will be the man who has kept gold in his own pocket and has let his confiding neighbor have the glittering gains the stock market offers.